STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

DRAFT

Date Introduced:	**02/24/06**	Bill No:	**SB 1643**
Tax:	**Sales and Use**	Author:	**Runner**
Related Bills:	**AB 2218 (Torrico)** **AB 2395 (Villines)** **AB 2595 (Arambula)** **SB 1291 (Alquist)**		

BILL SUMMARY

This bill would, beginning January 1, 2007, and ending January 1, 2012, reinstate the state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by new trades or businesses engaged in manufacturing, and broaden the exemption to include new software producers, as specified.

ANALYSIS

Current Law

Under current law, entities engaged in activities such as manufacturing, research and development, and software producing activities that make purchases of equipment and other supplies for use in the conduct of their activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for purchases of equipment used by these entities.

The statewide sales and use tax rate (7.25%) imposed on taxable sales and purchases of tangible personal property is made up of the following components (additional district taxes are levied among various local jurisdictions and are not reflected in this chart):

Rate	Jurisdiction	R & T Code
5.0%	State (General Fund)	6051, 6201, 6051.3, 6201.3
0.25%	State (Fiscal Recovery Fund)	6051.5, 6201.5
0.50%	Local Revenue Fund	6051.2, 6201.2
0.50%	Local Public Safety Fund	§35 Art XIII St. Constitution
1.00%	Local (0.25% County transportation funds 0.75% City and county operations)	7203.1

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

Proposed Law

This bill would add Section 6377 to the Sales and Use Tax Law to provide a partial exemption (5.25%) from the statewide sales and use tax rate operative January 1, 2007 until January 1, 2012, for the following purchases by a "qualified person":

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, pollution control equipment, buildings and foundations), as specified.
- Tangible personal property purchased for use primarily in research and development.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any qualifying equipment.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified person who will use that property as an integral part of the manufacturing process, as described.

The bill would define a "qualified person" as any new trade or business engaged in manufacturing activities, as described in the Standard Industrial Classification (SIC) Manual Codes 2011 and 3999, and software production activities as described in SIC Codes 7371 to 7373.

The bill would specify that the proposed exemption would *not* include 1) any tangible personal property that is used primarily in administration, general management or marketing, 2) consumables with a normal useful life of less than one year, except for fuels used in the manufacturing process, and 3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

As a tax levy, the bill would become effective immediately upon enactment.

Background

For a ten-year period ending December 31, 2003, the law provided a partial sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal SIC codes. The exemption applied to the state tax portion of the statewide rate for sales and purchases of qualifying property, and the in lieu income tax credit was equal to six percent of the amount paid for qualified property placed in service in California. Qualified property essentially was depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. Certain special purpose buildings were included as "qualified property." New manufacturers could receive either the benefit of the exemption, or claim the income tax credit. However, existing manufacturers could only receive the benefit of the income tax credit.

This sales and use tax exemption and income tax credit had a conditional sunset date. The sunset was to occur in any year following a year when manufacturing employment (as determined by EDD) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (indeed, it was LESS than the 1994 number by over 10,000), and therefore the MIC and partial sales tax exemption sunsetted at the end of 2003.

The manufacturer's sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments against and in support of these tax incentives were presented:

Arguments Supporting the MIC

- Investment Incentive—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.
- Relocation Incentive—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.
- Efficient Job Allocator—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.
- Other Arguments. Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- Inequitable Taxation—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.
- Relocation Rather Than Creation—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of "prisoners' dilemma"—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.
- Inefficient Development Policy—Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives "windfall benefits" in the form of reduced taxes.
- Ineffective Development Policy—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or expansion of business compared to the adverse fiscal effects that such measures can have on the state.

COMMENTS

1. Sponsor and purpose. This bill is sponsored by Senator Runner. It is intended to stimulate California's manufacturing and software production industry by providing tax incentives to new establishments engaged in these activities.

2. **Technical issues:**
   - In defining "qualified person," it is recommended that the bill require that the qualifying entity be *primarily* engaged in the activities described in the referenced codes. This is an important issue and one that generated a lot of disputes when the Board administered Section 6377 previously. Staff will work with the author's office in drafting amendments as the bill progresses through the Legislature.
   - Another issue relates to the proposed definitions for the types of property included or excluded from the proposed exemption. For example, on page 5, lines 22 and 36, the bill refers to the items having a useful life of one year or more (or less). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the

provision in the California income tax laws for depreciating assets should be incorporated into the bill.

- The original exemption was added in 1993 and referenced the SIC codes for purposes of qualifying entities. This bill would also reference those codes. However, the North American Industry Classification System (NAICS) has replaced the SIC codes, and should be used to reference the activities the author intends to be included within the scope of the exemption.
- On page 5, line 23, the bill incorrectly references paragraph (11). The correct reference should be paragraph (12).

3. **Related measures.** Other measures that would provide an exemption for manufacturing and other related activities include:

- AB 2218 (Torrico) - This bill would, for a 10-year period beginning January 1, 2007, provide a state sales and use tax exemption (5.25 percent) for purchases of qualifying tangible personal property by trades or businesses and their affiliates, as specified and defined.
- AB 2395 (Villines) - This bill would provide, for calendar years beginning on or after January 1, 2006, a state sales and use tax exemption for tangible personal property, as defined, purchased for use by manufacturers that have “gross aggregate gross assets” used in the manufacturing activity not exceeding $5 million. The bill would also provide a corresponding 6 percent income tax credit on purchases of similar property.
- AB 2595 (Arambula) - This bill would, among other things, require the Board to grant a “small size manufacturer,” as defined, a “sales and use tax offset,” as defined, against that manufacturer’s tax liability, as specified.
- SB 1291 (Alquist) - This bill would provide a state sales and use tax exemption (5.25 percent) for purchases on or after January 1, 2006, of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, software production, and newspaper printing, and for semiconductor, biotechnology and pharmaceutical clean rooms and equipment.

COST ESTIMATE

The Board would incur costs to administer this measure. These costs would be attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

This measure would add Section 6377 to the Revenue and Taxation Code to provides an exemption from the state sales and use tax for a new trade or business, specifically, those lines of business described in SIC Codes 2011 to 3999, inclusive, and 7371 to 7373, inclusive.

The NAICS has replaced the SIC codes, and there is no direct conversion for all industry classification from SIC to NAICS. However, the Economic Census does provide a bridge between the old and new classification systems as follows:

SIC 2011 to 3999:	NAICS 31 to 33 (manufacturing)
SIC 7371:	NAICS 541511 (custom computer programming services)
SIC 7372:	NAICS 5112 (software publishers) & NAICS 334611 (reproducing)
SIC 7373:	NAICS 541512 (computer systems design services)

For the purpose of this estimate, we will use the bridge to the NAICS classification that provides the nearest match to the old SIC numbering system. The Annual Survey of Manufacturers, Geographic Area Statistics 2004, Table 3, a US Census Bureau publication, provides that for NAICS 31-33 for California, machinery and equipment expenditures amounts to $9.7 billion. This measure also includes tangible personal property purchased in the performance of a construction contract for a qualified person who will use the tangible personal property as an integral part of the manufacturing process. Construction of building other structures expenditures amounted to about $2 billion. We estimate that about half of the expenditures would amount to labor charges for installation that are exempt from the tax. This would result in a total of $10.7 billion in NAICS 31-33 capital manufacturing expenditures for machinery and equipment. The bill also includes fuel used or consumed in the manufacturing process. The survey reported $2.3 billion of purchases of fuels.

The Annual Capital Expenditures 2004, Table 4a, a US Census Bureau publication, provided US expenditure data for the other codes. For NAICS 5112, US equipment expenditures was $2.8 billion. Based on California's population, we estimate California expenditures to be $336 million (12% × $2.8 billion = $336 million) annually.

The Annual Capital Expenditures 2004 does not provide a breakout expenditures for codes 541511 and 541512, as they are included in code 5415, (computer systems design and related services). For NAICS code 5415, the 2004 US equipment expenditures was $6.2 billion. Based on California's population, we estimate that California's expenditures amount to $744 million (12% × $6.2 billion = $744 million).

From information we gathered from the 2002 Economic Census, we estimate that NAICS 541511 and NAICS 541512 represented 42% and 48% of NAICS 5415, respectively. Using the two ratios, we estimate equipment expenditures of $312 million for custom computer programming services and $357 million for computer system design services (NAICS 541511: 42% × $744 million = $312 million) and (NAICS 541512: 48% × $744 million = $357 million) annually.

California Expenditures - Summary

Classification		Expenditures		
NAICS 31-33	Machinery & Equipment	$	9.7	billion
	Construction contracts		1.0	billion
	Fuel consumption		2.3	billion
NAICS 541511	Custom computer programming services		0.3	billion
NAICS 51121	Software publishers		0.3	billion
NAICS 541512	Computer system design services		0.4	billion
Total expenditures		$	14.0	billion

The bill proposes that the exemption apply to new businesses only. We estimate that the qualifying expenditures for new businesses would amount to 0.9 percent, resulting expenditures of about $126 million (0.9% × $14 billion = $126 million) annually.

Revenue Summary

The annual revenue loss from exempting $126 million is estimated to be $6.6 million ($126 million × 5.25%).

	Revenue Loss (in millions)	
State (5.0%)	$	6.3
Fiscal Recovery Fund (0.25%)		0.3
Total	$	6.6

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